The efficiency of the Macedonian banking sector

1. Introduction

The Macedonian banking sector has grown rapidly in the past few years. However, its current stage of development, measured by the level of financial intermediation, is still lower compared to the other transition countries (of Central and Eastern Europe) and the EU member states. The banking sector in Macedonia has a dominant share in the overall financial sector, and comprises 21 bank and 15 saving houses[1]. The banks have the majority assets of the banking sector, whereas the saving houses manage only 1.3% of the total assets. The banking sector is largely concentrated with 2 banks having 55.5% of the total assets and 55.9% of total bank activities. At the end of the first half of 2004, 95.1% of banking capital has been privatized[2], and foreign capital is present in 15 banks (foreign capital has a 45.7% share in total banking capital). Out of the 15 banks, 8 banks (with 47.5% share in total assets) have foreign investors as majority shareholders.

The comparative analysis with the other transition countries shows that the Macedonian banking sector is lagging behind in the bank consolidation process. In the group of 16 transition countries, Macedonia (after Slovenia) has the highest number of banks per population. Despite the large number of banks, a high concentration of assets is present, with the two largest banks having 55.9% of total assets and the 12 smallest banks accounting for only 13.9% of total assets. This structure results in lack of competition among banks, thus hurting their efficiency. On the other hand, Macedonia ranks 14th for the foreign banks to total banks ratio, so the banking sector needs to further attract foreign investors. The entry of foreign capital is particularly important for strengthening competition and achieving higher efficiency. The advantages of foreign banks operating in Macedonia are multiple: transfer of *know-how*, investment in IT, using modern risk management methods, additional capital etc.

Table 1. Banking sector in transition countries

Country	Number of banks	Foreign owned banks	Population (in millions)	Banks per million population	Foreign banks to total number of banks ratio (in percentage)
Slovenia	22	6	2	11.0	27.3
Macedonia	***21***	***8***	***2***	***10.5***	***38.1***
Latvia	23	10	2.3	10.0	43.5
Bosnia and Herzegovina	37	19	3.8	9.7	51.4
Croatia	41	19	4.4	9.3	46.3
Serbia and Montenegro	47	16	8.3	5.7	34.0
Estonia	7	4	1.4	5.0	57.1
Albania	15	13	3.2	4.7	86.7
Bulgaria	35	25	7.8	4.5	71.4
Slovakia	21	16	5.4	3.9	76.2
Hungary	38	29	10	3.8	76.3
Moldova	16	9	4.3	3.7	56.3
Lithuania	13	7	3.5	3.7	53.8
Czech Republic	35	26	10.3	3.4	74.3
Poland	58	46	38.3	1.5	79.3
Romania	30	21	21.7	1.4	70.0

Source: European bank for Reconstruction and Development (EBRD) Transition report 2004

2. Analysis of the efficiency of the banking sector

[1] As of 30.06.2004. Source: Report on the banking supervision and the banking sector of the Republic of Macedonia for the first half of 2004. All further analysis for 2004 relates to data for the first half of 2004 only.
[2] Macedonian Bank for development promotion is fully state owned bank, and is not part of the analysis.

The efficiency of the banking sector can be measured through quantitative and qualitative indicators. The quantitative analysis is based on the Dupont analysis of the financial results, comparative analysis of interest margins and bad loans ratio, whereas the qualitative analysis is based on EBRD's banking sector reform index.

2.1. Analysis of financials results

The Macedonian banking sector has been constantly growing since 2000 (see Table 3), with increase in all major balance sheet categories. Bank's liabilities (deposits) show a positive growth trend resulting in increased credit potential of the banks. However, the changes in the loan structure are not all positive. Despite a 33.9% growth of clients' credit in the period 2000-2003, loans to other banks (which are mainly in the form of deposits on accounts with other banks) had a higher growth rate of 36.7%. Although, banks' lending has increased significantly in 2004, the balance sheet structure depicts restrictive credit policies within the banking sector through low risk investments in other countries. Investments in foreign banks (mainly deposits) have a dominant share (84.5%) in the total investments in other banks, and the low yields of these assets (due to low interest rates on financial markets in the past few years) have negatively affected profitability rates during this period. Moving credit potential out of the country has negative effects not only on the banks' profitability, but also to the overall economy as it reduces the available assets for financial support of the private sector.

Table 2. Balance sheet of the banking sector (2000-2004)

in million denars	31.12.2000	31.12.2001	31.12.2002	31.12.2003	30.06.2004	*2004 / 2000*
Total assets	**81,999**	**105,633**	**93,213**	**104,875**	**109,159**	***33.1%***
Cash and balance with NBRM	6,712	26,470	6,079	5,625	4,847	*-27.8%*
Placements to other banks	27,285	29,576	33,803	37,301	37,711	*38.2%*
Accounts with foreign banks	24,154	20,424	29,338	30,994	31,872	*32.0%*
Placements to clients	27,725	30,642	32,070	37,111	42,119	*51.9%*
*Interest earning assets**	*67,193*	*96,670*	*81,654*	*91,367*	*95,800*	*42.6%*
Total liabilities	**81,999**	**105,633**	**93,213**	**104,875**	**109,159**	***33.1%***
Liabilities	62,897	86,474	73,934	84,800	88,680	*41.0%*
Equity	19,102	19,159	19,279	20,075	20,479	*7.2%*

Source: National Bank of the Republic of Macedonia (NBRM)
* Calculation of the author.

The components of the income statement show divergent movements in the analyzed period. Whereas income categories have decreased or remained unchanged, expenditures have increased resulting in a lower profit margin. Earnings after tax in 2003 amounted to 448 million denars, compared to 645 million denars in 2000. To have a better understanding of the reasons behind these movements, a more detailed analysis is needed.

Table 3. Income statement of the banking sector (2000-2003)*

in million denars	2000	2001	2002	2003	2003 / 2000
Net interest income	2,594	1,858	2,430	2,536	-2.2%
Interest income	5,165	4,483	5,428	5,161	-0.1%
Interest expense	-2,572	-2,625	-2,999	-2,625	2.1%
Net provisions	-2,922	-2,542	-1,798	-2,334	-20.1%
Provisions	-3,415	-3,250	-2,738	-3,298	-3.4%
Recovery regarding provisions	493	708	940	964	95.6%
Net interest income after provisions	-328	-684	631	202	-
Net fees and commissions income	1,866	1,802	2,287	1,927	3.2%
Other income	3,039	2,020	2,259	2,902	-4.5%
Other income	734	637	474	766	4.4%
Extraordinary income	2,306	1,384	1,785	2,136	-7.4%
Operating costs	-3,084	-3,525	-4,059	-4,281	38.8%
Other expenditures	-888	-1,113	-1,001	-539	-39.3%
Operating income	**11,500**	**10,346**	**11,713**	**11,619**	**1.0%**
Operating expenditure	**-10,691**	**-10,860**	**-11,242**	**-11,088**	**3.7%**
Earnings before taxes	809	-514	470	531	-34.3%
Taxes	-164	-107	-75	-83	-49.3%
Net income	**645**	**-620**	**396**	**448**	**-30.5%**

Source: NBRM

* Income statement data for 2004 is not included as it is only available for the first half of the year, making it not comparable.

2.2. Dupont methodology for financial statements analysis

The Dupont model is the most often used tool for financial ratio analysis of a company or an industry. Dupont analysis of bank performance is a modified version of the Dupont model (see Cole, 1973 and Dietrich, 1996) taking account the specifics of banks' activities as well as the balance sheet and income statement.

2.2.1. Dupont methodology for banks

The starting point of the bank performance analysis is to calculate the rate of ***return on equity (ROE= EAT/BVE)***. ROE is the ratio between after tax earnings and book value of equity, and it presents the earnings per unit of invested capital, making it a universally comparable indicator for measuring the profitability of an investment. ROE consists of three components: ***pull-through*** (U = EAT/EBT), ***financial leverage*** (LEV = TA/BVE) and ***return on assets*** (ROA = EBT/TA).

ROE = U x LEV x ROA

EAT - Earnings after tax
EBT - Earnings before taxes
TA - Total Assets
BVE - Book value of equity

Pull-through measures the success of the bank's tax management policy, as well as the effects of the changes in the tax legislature on the bank's financial statements. ***Financial leverage*** shows how many denars of assets a bank has per one denar of equity. The ***return on assets*** is the most widely used indicator in financial ratio analysis, and it measures the success of creating revenues after all expenditures are covered. ROA is the ratio between earnings and total assets, measuring the income per unit of assets, and is an adequate indicator for comparing firms from the same industry[3]. The changes in the ROA are often the main cause of the most

[3] ROA cannot be used for comparison of firms from different industries, because of the differences in the balance sheet structure.

important changes in bank's performance, whereas the other two components (U and LEV) are relatively stable. In order to further analyze the determinants of the bank's profitability, the ROA is further disaggregated into three components: ***burden*** (B = NNIR/TA), ***earning assets ratio*** (EAR = EA/TA) and ***net interest margin*** (NIM = (IR-IE)/EA).

ROA = B + EAR x NIM

NNIR - Non interest revenue, net
EA - Earning assets
IR - Interest revenue
IE - Interest expense

Burden measures the bank management's success in maintaining control over operating costs. It is normal for the bank's burden to have a negative value, since non-interest revenues (revenues from fees and commissions) are not able to cover all non-income related costs. The Macedonian banks are an exception to this rule due to the high share of non-interest revenues to total revenues. ***EAR*** usually has a minor role in determining changes in ROA, but it stands as a good indicator for analyzing the strategic focus of individual banks. The ***net interest margin*** is a key indicator in the financial analysis showing the net income from investing through borrowed funds. NIM can be further disaggregated into: ***return on earning assets*** (REA = IR/EA), ***cost of liabilities*** (COL = IE/L) and ***liabilities to earnings ratio*** (LEA = L/EA)**.**

NIM = REA - COL x LEA

L – Liabilities

The ***return on earning assets*** directly connects earning assets and interest revenue generated by them. Thus, it is a measure of the average rate of lent funds. On the other hand, ***COL*** is an indicator of the average price of borrowed capital. ***LEA*** measures the intensity of the bank's investment activities.

2.2.2. Results of the analysis

Macedonian banks have attained low profitability rates in the past 4 years (overall loss in 2001 due to the negative impact of the security crisis). The rate of return on equity is highest in 2000, followed by the red figure in 2001. From 2002 onwards, the rate of return on equity for the Macedonian banking sector is maintained at low 2 percent, still below the 2000 level. The analysis by size of assets shows that large and medium sized banks achieve higher profitability than small banks. Furthermore, small banks have the lowest earnings per employee, as well the lowest assets to employee ratio. This confirms the conclusion that the Macedonian banking sector requires consolidation and enlargement of the small banks. The ROE components show that the rates of return are mainly determined by the changes in the ROA. The tax management policy does not play a significant role (U has increased since 2000, but remains stable[4]).

Table 4. Financial ratios for the Macedonian banks

[4] U plays no role in 2001, as the banking sector ended the year with a loss.

	2000	2001	2002	2003	2004*
ROE = U x LEV x ROA	**3.8%**	**-3.2%**	**2.1%**	**2.3%**	**2.2%**
U (EAT/EBT)	0.80	1.21	0.84	0.84	1.00
LEV (TA/E)	4.5	4.9	5.2	5.0	5.3
ROA (EBT/TA)	1.0%	-0.5%	0.5%	0.5%	0.4%
ROA (NNIR/TA + EA/TA x NIR/EA)**	**1.0%**	**-0.5%**	**0.5%**	**0.5%**	**0.2%**
B (NIR-NIE / TA)	1.47%	0.18%	-0.16%	0.33%	-0.34%
NNIR	*1137*	*171*	*-161*	*329*	*-364*
EAR (EA / TA)	87.1%	103.0%	82.1%	92.2%	89.5%
NIM (IR - IE / EA)	-0.5%	-0.7%	0.8%	0.2%	0.6%
NIM = REA - COL x LEA	***-0.5%***	***-0.7%***	***0.8%***	***0.2%***	***0.6%***
REA (IR / EA)	2.6%	1.3%	3.3%	2.0%	1.3%
COL	-3.3%	-2.2%	-2.8%	-2.0%	-0.8%
LEA	0.94	0.89	0.91	0.93	0.93

Source: Author's calculations.
* Data is for the first half of 2004.
** There is a small deviation from the calculations of the NBRM.

The rate of (before tax) return on assets in the period 2002-2004 is also lower compared to 2000. According to the Dupont model, the ROA consists of net interest revenues and net non-interest revenues. Macedonian banks are unique in terms that banks' burden B is positive. This indicator is expected to show a negative value, since revenues from non-core activities normally are not sufficient (nor expected) to cover the costs of all operating and other costs. In the period 2000-2003, this indicator has a positive value (except for 2001), and in the first half of 2004 it again shows a negative value. On the other hand, the net interest margin which measures the banks' efficiency in performing their core activity (financial intermediation) is negative both in 2000 and 2001 (-0.5% and –1%, respectively). NIM has been positive in the period 2002- 2004, however with a declining trend (0.8% in 2002 and 0.6% in 2004). The decline compared to 2002 is mainly due to the decrease in the weighted average lending rate. The cost of liability has also followed a similar (but less acute) trend, due to the decrease in deposit rates. From the above analysis it can be concluded that the bank profitability is largely determined from performing non-core activities, and not from deposit-taking and lending. More detailed analysis shows that extraordinary revenues have dominant share in total non interest revenues. This category includes provisions for credit exposure, which are actually part of the core activity of lending (thus reducing interest income after provisions in the previous period)[5]. Transferring provisions from extraordinary revenues to net interest income would improve the financial results. However, the conclusion remains that non interest revenues play a substantial role in determining banks' profitability.

2.3. Comparative analysis of bank profitability

Historical time analysis shows that Macedonia is the only country in the region with a declining profitability in the period 1998-2002[6]. Compared to the average (for the countries in the region) ROA and ROE of 2% and 18.2%, respectively, the profitability of Macedonian banks is significantly lower. The results are similar in the comparison with the other transition countries. Furthermore, the banking systems in the other countries operate with lower interest margins, thus strengthening the conclusion that the Macedonian banking system is inefficient.

Table 5. Bank profitability in transition countries

[5] Banks are required to allocate provisions for each loan. Provisions are calculated as a percentage of the loan depending on the loan classification (in category A, B, V, G or D).
[6] According to the study "Overview of the Banking Sector", National Bank of Greece.

	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE
	2000		2001		2002		2003	
Lativa	2	19	1.5	19	1.3	14.7	-	-
Estonia	1.1	8.6	2.5	18.8	2.6	19.2	-	-
Albania	2.1	20.6	1.5	21.6	1.2	19.1	-	-
Romania	1.5	12.5	3.1	21.8	2.6	18.3	-	-
Slovakia	1.4	25.2	1	22.7	1.2	31.1	1.3	30.5
Hungary	1.3	15.1	2	20.2	1.8	19.7	2.1	25.8
Czech Republic	0.7	13.1	0.7	14.4	1.2	25.4	1.1	22.7
Croatia	1.2	10.5	1.3	6.7	1.3	20.4	1.5	18.7
Bulgaria	2.8	22.6	2.6	19.3	2	14.9	2.4	17.9
Slovenia	1.1	11.4	0.5	4.8	1.1	13.3	1.2	15.7
Lithuania	0.5	5	-0.1	-1.2	1	9.8	1.4	13.5
Poland	1.5	14.5	1.3	13.1	0.8	5.2	1.2	9.5
Macedonia	0.8	3.8	-0.7	-3.2	0.4	2.1	0.5	2.3

Source: Global financial stability report, IMF 2004, Bank of Albania, Romanian Central Bank, NBRM.

2.4. Non-performing loans

The share of non-performing loans in the total credit portfolio depicts the performance and results of a bank's credit policy. All transition countries inherited poorly performing banking systems, where credit policies where based on political and social factors rather than banking principles. This situation resulted in a high level of non-performing loans on the banks' balance sheets. The economic recession, which took place in the first transition years in the transition countries, further ignited the problem with non-performing loans. During the transformation period, consolidation and rehabilitation programs where introduced resulting in write-off of non-performing loans, thus improving the balance sheet of the banking sector. This trend has been present in Macedonia as well. In the period 1995 – 2004, the share on nonperforming loans[7] decreased from 44.4% to 13.8%. However, the current level of bad loans is still higher than the other SEE countries *(see table 7)*. The analysis of the Macedonian banking system shows that small banks have the highest share of bad loans. Having in mind the previous results where Macedonia ranks second by the number of banks per population, it can be concluded that consolidation in the banking sector is crucial. Mergers and acquisitions among the smaller banks will help strengthen the credit portfolio, reduction of credit risk and improve performance.

2.5. Interest margins

The interest margin measures the difference between the deposit and lending rate, and is an important indicator for the efficiency of a bank or the entire banking sector. The difference between what the banks are charging and what they are paying to the depositors shows the level of the operating costs and the efficiency of the banks in the financial intermediation process. Furthermore, the interest margin indicates the level of competition among banks as well as foreign competition in the banking sector (credit lines from foreign sources, availability of credits from foreign banks etc.). Compared to the other transition countries, Macedonian banks operate with high interest margins, meaning they are less efficient (Macedonia ranks 3rd among 16 transition countries for 2003). The banking sector has registered a positive trend of decrease in interest margins during the past few years. A significant decline occurred in 2004, with interest margin going below 6 percentage points.

Table 6. Interest margins in transition countries (for 2003)

[7] Nonperforming loans comprise loans under V, G and D category (EBRD definition), which is slightly different than the NBRM definition of nonperforming loans (where not all V category loans are considered nonperforming).

Country	Nonperforming loans	Interest margin	Effective interest margin
Poland	25.1	7.7	5.0
Serbia and Montenegro	23.8	-	-
Macedonia	***15.1***	***7.8***	***5.6***
Croatia	9.4	10.3	9.2
Slovenia	9.4	5.1	4.2
Slovakia	9.1	4.7	4.0
Bosnia and Herzegovina	8.3	-	-
Moldova	6.4	5.2	4.0
Czech Republic	5.0	3.0	2.8
Albania	4.6	2.9	2.4
Bulgaria	4.4	6.3	5.9
Hungary	3.8	2.5	2.1
Lithuania	2.6	4.9	4.8
Romania	1.6	15.4	15.0
Latvia	1.5	2.8	2.7
Estonia	0.5	2.7	2.7
*EU**	-	*3.5*	-

Source: EBRD Transition Report 2004 and NBRM.
* Data for EU15.

The aim of the interest margin analysis is to show the efficiency of the bank operations, and a more proper measure of the efficiency in the usage of acquired funds is the effective interest margin. This indicator is a modified version of the interest margin in which the lending rate is reduced for the share on non-performing loans, since these loans do not earn any income by definition.

*effective lending rate = lending rate * (1 - % of NPLs)*

The results from the comparative analysis are similar as the previous. The banking system in Macedonia operates with higher margins than most transition countries. In 2003 and 2004, a positive trend of declining in the effective interest margin has been registered.

2.6. EBRD index of reforms

EBRD calculates the index of reforms (for various sectors) for the transition countries, and publishes its results annually in the *Transition Report*. Two qualitative reform indicators refer to the financial system: ***index of reforms in the banking sector*** and ***index of reforms in non-banking financial institutions***. According to the first index, Macedonia has a score of 2.7 out of 4, putting it on the bottom of the list together with the other countries of the Western Balkans. The situation is almost identical for the development of the non-banking financial institutions. The two reform indexes have (expected) high correlation, since the efficiency of the banking system depends on the development of other financial institutions which will increase the competition in the financial sector. It can be concluded that improving the performance of the banking system requires rapid development of non-banking financial institutions in order to boost competition.

3. Factors determining the low efficiency

The banking sector is rather specific in terms of the factors that determine the bank performance, and the bank operations are strongly influenced by exogenous developments. Bank liabilities (taken deposits) are mainly determined by the sustainable economic stability and future expectations of the economic and political environment in the country and the region. The assets side is also influenced by macroeconomic developments in the country and

the region, as well as by the monetary and fiscal policy. The inefficiency of the banking system is mainly determined by: legislature, macroeconomic environment and the bank management[8].

3.1. Legislature

The legal acts related to the functioning of the financial system are a key factor that determines the overall performance of the banks. This particularly relates to the legal acts regarding the collection of collateral assets. The efficiency of court procedures is an essential requirement for good bank performance, as it allows banks to pursue a more efficient (and more expansive) credit policy. If the judicial system does not allow for timely, efficient and simple resolution of court disputes, the banks' credit portfolio will have high share of non-performing loans and investments in securities (which is exactly the case in the Macedonian banking system). On the other hand, such a credit portfolio implies higher lending rates and reduced possibility for crediting (having only few investment projects that can earn such a high return to be able to cover to high interest costs). The inability to provide more credit to clients would then result in risk free investments (such as CB-bills or government bills), even keeping cash on its own account. The above mentioned scenario is a complete capture of the current situation in the Macedonian banking system. The weakness in the judicial system has resulted in a large share of uncollected loan repayments (NPLs), even though there is a positive trend in declining NPLs (13.8% in 2004). As a result, banks operate with high interest margins (lending rates), meaning they are unable to invest all of their assets as loans. This is reflected through the excess liquidity banks have on their accounts at the central bank. In 2003, the average excess liquidity of banks was around 28 percent.

In 2003 the EBRD introduced a new method for measuring reform progress in the legislature (related to the banking sector) in the transition countries, as an addition to the existing regional survey for the reforms in the legislature related to secured transactions[9]. The results of the survey on secured transactions[10] (which began in 1999) show that Macedonia falls in the group of countries with low progress in reforms[11]. The aim of the new survey[12] is to assess "the laws in action", meaning how the legislature on secured transactions is applied in the court practice in these countries[13]. The survey measures the level of reforms through the following indicators: (1) time needed to recover the assets, (2) amount expected to be recovered (as % of total value) and (3) simplicity of the process. According to this indicators, Macedonia ranks in the middle of the 15 SEE and CEE countries, lagging behind the advanced transition countries, and the least developed countries such as Serbia and Montenegro, Bosnia and Herzegovina, Albania, Moldavia (and Romania) at the bottom of the list.

3.2. Macroeconomic environment

The performance of the economy has a significant impact on the development of the banking sector. The level of economic development as well as the current economic trends strongly influences both the asset and liability side of the banks' balance sheets. The frozen deposits, collapse of the pyramid schemes and the bankruptcy in several small banks during the 90's had a substantial negative impact on the confidence in the banking system. As a result, Macedonian banks operated with a very limited deposit base, with most savings being stored "under the matrices" (and in foreign currency). In November 2001, NBRM conducted a survey to estimate the size of foreign currency savings outside the banking system. The results of this survey showed there are between 1 and 1.5 billion deutschmarks of savings circulating outside

[8] This was the conclusion from the conference "Reforms in the financial sector in SEE" organized by the South East European Research Center, which took place in Skopje on June 10th, 2004.
[9] In Macedonia this has been regulate with the Law on mortgage and Law on execution of court decisions.
[10] Regional survey of secured transactions.
[11] Countries are ranked in five groups: advanced countries, countries with significant progress, countries with low progress, countries with minor progress, and countries with no reforms.
[12] New Legal Indicator Survey (NILS) 2003.
[13] The purpose of secured transactions is to mitigate the risk of providing credit, thus enhancing creditors' confidence that they can recover their assets from mortgaged assets.

the banking system[14]. The improved economic environment, strengthened banking supervision and the creation of the Fund for insurance of deposits resulted in a return of confidence in the banking system. However, a key milestone in the transfer of savings back to the banking sector was the introduction of the euro and the need for conversion of the 12 national currencies into euro, which began on 01.01.2002. The banks offered conversion with no commission if funds are deposited in a savings account for a minimum of 15 days. So, in the last quarter of 2001, households' deposits had an enormous increase, ending 3.6 times higher (or 27.7 billion denars) on year-to-year basis. During the first quarter of 2002 there was withdrawal of deposits, but between 60 and 70 percent of the new deposits remained in the banking system.

The poor economic performance and the developments in the region also had a negative impact on banks' credit activity. In an environment of economic and political instability, low level of foreign investments and high interest rates, banks had a difficult time finding suitable investment projects to invest in. The low usage of foreign credit lines (only 45.7%[15]) which are available with low interest rates is a further proof of the limited opportunities for investing. Thus, it is not surprising that investments in other banks (of which 80% are in foreign banks) are higher than loans to clients. The high level of funds deposited in foreign banks, which are low risk but also low yield, has adversely affected banks' profitability.

3.3. Management

The skills and capacity of the top management is also an important aspect that determines the performance of any company. The managers of the Macedonian banks play a significant role in the performance of the banking sector. The role of the management can be analyzed from two aspects: the skills of the top managers and the functioning of the system of corporate governance. In addition to the previously mentioned factors, the management in Macedonian banks further contributes to the present poor performance of the banking sector. This can be measured through the low level of investments in IT (which has been one of the main contributors for increased efficiency in the past decade), little use of latest risk management methods, poor customer orientation etc. This situation is clearly observed through many examples and anecdotal evidence. For example, whereas Estonia has 93% of transactions conducted online[16], (only few) Macedonian banks have only recently introduced online banking. Customer orientation has been the main company focused for decades in the developed countries, but Macedonian banks (again only some) only recently have introduced a "yellow line" to protect the privacy of the customer (an investment of less than 10 euros). Significant progress has been made in the past few years in developing new risk management methods and models (for reducing credit, foreign exchange, market, liquidity risk etc.), however the implementation of these new findings lacks in most Macedonian banks. One of the reasons is that only a fraction of top managers have participated in trainings on these topics. My conclusions are supported by the bankers themselves. I tried to conduct a survey among bank mangers in which (among other things) I asked top managers to provide their opinion on the impact of the management on the bank performance. Although I did not receive the critical amount of feedback to publish the results[17], I received enough answers on this particular question, and the results was the bank CEO's agree that the skills of bank managers in Macedonia represent a significant constraint on banks' profitability. The second aspect of the role of the management's role is the corporate governance in the banking sector. Corporate governance[18] depicts the relationship between the company and the interest parties such as shareholders, managers, creditors, employees, clients etc. The lack of an adequate corporate

[14] "Stranskite valuti vo optek vo zemjite vo tranzicija i pridonesot na evro-konverzijata za merewe na nivniot iznos - so poseben osvrt na Republika Makedonija", NBRM 2001 godina.

[15] Source: Ministry of Finance, share of unused funds is author's calculation.

[16] Banking markets in central and eastern Europe (VIII): The Baltic countries - moving in the economic fast lane

[17] I would like to express my gratitude to those CEO's that have provided feedback.

[18] The World Bank defines corporate governance as a mix of laws, regulations, and adequate practice in the private sector, which allows companies to attract financial and human capital, to function efficiently, by generating long-term economic value to their shareholders, while respecting the interests of the other stakeholders and society.

governance is not only present in banks, but in the overall corporate sector, having detrimental impact on the quality of the decision-making process in the companies. Lack of transparency and unclear relationships between shareholders, managers and the clients (which are very often the same) are particularly present within smaller banks, and seriously jeopardize effective corporate governance[19].

4. Conclusions

The historical analysis and comparative approach with the other transition countries point out to an insufficient level of development and poor performance of the Macedonian banking sector. Measured by the share of total assets to GDP, the Macedonian banks are lagging well behind the more advanced transition countries. The structure of the Macedonian banking system shows high concentration, while at the same time a large number of small banks. Macedonia has the second largest number of banks per population, whereas over a half of bank assets are owned by the two largest banks. The result of this inadequate structure is lack of competition in the banking sector, which seriously undermines the banks' efficiency. The DuPont analysis of the banks' financial results shows high level of non-interest revenues (from fees and commissions) and lesser interest revenues, meaning that earnings from non-core activities (rather than the core business of financial intermediation) are the main determinant of the banks' profitability. Having this in mind, the fact that Macedonian banks are the least profitable among the transition countries comes as no surprise. The high level of non-performing loans and high interest margins also point out to the poor performance of the banking system, and trying to reduce this two will have further negative impact on rates of return. The EBRD index on reforms (in the banking sector and non-banking financial institutions) is an additional indicator for the insufficient level of reforms compared to the other transition countries.

The reasons for the poor performance of the banking sector are both endogenous and exogenous. The most significant exogenous factors are the legislature and the macroeconomic environment. These two factors have had adverse impact on the banking system in the past. However, the latest reforms in the judicial sector (and banking sector related legislature) as well as the improved economic environment are a positive signal for an enhanced performance in the future. The skills of bank managers and the inappropriate system of corporate governance present an additional obstacle for improved efficiency and profitability of the banks in Macedonia. The managers have not been following latest trends in banking regarding risk management methods, customer orientation, investment in IT etc. Corporate governance also remains an issue for the overall corporate sector, and the problems with lack of transparency and mixed shareholders, managers and client relationships are particularly acute in small banks.

The banking system has an irreplaceable role in providing financial assistance to the private sector and promoting economic growth. Thus, the efficiency of the banking system allows for more efficient (cheaper) financing of private entities, resulting in increased investments for companies and higher consumption for households. In the current environment where Macedonian enterprises are facing undercapitalization and low inflow of FDI, the banks' role as a source of financing is even more important for promoting investments and economic growth. The results of the 2002 BEEPS[20] survey show that half of companies in Macedonia finance only up to 20% of the working capital with bank credits. There have been some positive trends moving the banking sector closer to the standards of the advanced transition countries (now EU member countries). The most significant trend is the reduction of the lending rates, which resulted in increased lending and narrowing of the interest margin. On the other hand, the reduction of deposit rates has not decreased the positive trend of deposits growth, implying a strengthening of confidence in Macedonian banks and return of financial assets of households

[19] Macedonia has not yet introduced "fit and proper" standards for assessment of the capability and adequacy of the shareholders and managers in the banks.
[20] The Business Environment and Enterprise Performance Survey (BEEPS) II, EBRD and the World Bank, 2002.

in the banking system. The expansion of the banks' credit portfolio and introduction of the latest bank products and services (such as online banking) in some banks has resulted in improved performance. This positive trend needs to have a broader acceptance within the banking sector and to continue with more intensive pace, in order for Macedonian banks to achieve the level of development of the advanced transition economies.

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